

Question #1 of 60

A) Standard III(D) only.

Explanation

By implying that the composite's past performance is representative of future performance, Burton is in violation of Standard III(D) Performance Presentation. A member or candidate should give a fair and complete presentation of performance and not state or imply that clients will obtain a rate of return that was generated in the past.

Burton's references to the CFA program in his marketing materials were acceptable according Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program. The Standard states that members and candidates may make references to the rigor of the program and the commitment of members and candidates to ethical and professional standards. However, statements must not exaggerate the meaning or implications of the designation, membership in CFA Institute, or candidacy.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #2 of 60

C) not a violation because the brokerage is the property of the client.

Explanation

According to CFA Institute Standards of Professional Conduct, client brokerage is the property of the client; client-directed brokerage does not violate the duty of loyalty to clients. Members should disclose to the clients if such arrangements does not result in best execution for the clients (but this stipulation is not applicable in this case).

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #3 of 60

C) only after fully disclosing the referral arrangement to clients and prospective clients.

Explanation

Standard VI(C) Referral Fees states that members and candidates must disclose to their clients and prospective clients any compensation or benefit received for the recommendation of services. In this case, Burton may accept a referral fee if he discloses it to the client so that the client may evaluate any partiality shown in the recommendation.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #4 of 60

C) No, because it allowed an analyst to participate in a marketing road show for a company that he covers.

Explanation

According to Requirement 4.0 Investment Banking of the CFA Institute Research Objectivity Standards, firms must prohibit communication between members of the research and investment banking divisions. Recommended compliance procedures for Requirement 4.0 include prohibiting analysts from participating in marketing road shows. Therefore, while Security Bank complies with all of the requirements of the Standards, it does not comply with all of the recommendations.

Under Requirement 10.0 Disclosure, firms are required to disclose all conflicts of interest to which the firm or its covered employees are subject, including whether the firm engages in any investment banking or other corporate finance activities. Therefore, "publicly revealing" the relationship is not a violation of the client's confidentiality.

For Further Reference:

Study Session 1, LOS 3.b

SchweserNotes: Book 1 p.81

CFA Program Curriculum: Vol.1 p.212

Question #5 of 60

- B)** in violation of Standard V(A) Diligence and Reasonable Basis for not thoroughly analyzing the investment before making a recommendation and in violation of Standard III(C) Suitability for not determining the appropriateness of the investment for the portfolio.

Explanation

Standard V(A) Diligence and Reasonable Basis states that the member or candidate must exercise diligence, independence, and thoroughness before making an investment recommendation. The Standard also requires that members and candidates have a reasonable and adequate basis supported by research and investigation for any investment recommendations or actions. Burton made his purchase recommendation to Crossley purely on the basis of the Security Bank road show and did not perform his own evaluation to determine whether or not the SolutionWare IPO was a good investment opportunity. Burton has therefore violated Standard V(A).

Standard III(C) Suitability was also violated because there is no indication that Burton made any effort to determine if the investment was appropriate for Crossley's portfolio. Burton should have determined that the investment was consistent with Crossley's written objectives and constraints before he recommended the investment. Even though he later determined that the investment was suitable, he did not know this was the case before he told Crossley that he should purchase shares in the IPO. Standard III(B) Fair Dealing (and not I(B) Independence and Objectivity) would also be violated if Burton did not afford all the clients for whom the IPO was suitable to participate in the offering. Standard III(B) Fair Dealing (and not standard I(B)) would also be violated if Burton did not extend IPO participation to all portfolios meeting suitability criteria.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #6 of 60

- A)** is in violation of the Standards because his actions adversely affected the interests of Crossley.

Explanation

Standard VI(B) Priority of Transactions clearly states that investment transactions for clients must have priority over members' and candidates' transactions. Members and candidates can profit from personal investments as long as the client is not disadvantaged by the trade. By taking a portion of the IPO shares for his own account, Burton has ensured that Crossley's order will not be completely filled. It does not matter that the trade allocation was done on a pro-rata basis; Burton should have placed his client's transaction ahead of his own.

For Further Reference:

Study Session 1, LOS 2.a

SchweserNotes: Book 1 p.5

CFA Program Curriculum: Vol.1 p.21

Question #7 of 60

C) $X_t = b_0 + b_1X_{t-1} + b_2X_{t-12}$.

Explanation

The best formulation for Smith's retail sales data would include the intercept, the lag one coefficient, and the lag twelve coefficient. First, note that in the second regression, all of these are statistically significant, with a p-value of less than 1%. Also, the second regression that included the lag twelve term has a higher adjusted R-square at 0.92 compared to 0.83 in the first regression that omits the lag twelve term. Lastly, we should suspect that the lag twelve term is appropriate because this is seasonal, monthly data.

We could have also looked at the significance of the autocorrelations if they had been provided. If any are significant in either regression, another lag term would be added to the autoregressive model.

For further reference:

Study Session 3, LOS 11.d, I

SchweserNotes: Book 1 p.193, 203

CFA Program Curriculum: Vol.1 p.415, 442

Question #8 of 60

C) \$6,667.

Explanation

To forecast the sales this month, we first calculate the change in the log of sales last month:

$$\Delta \ln \text{sales}_{t-1} = \ln(6,270) - \ln(6,184) = 8.7435 - 8.7297 = 0.0138$$

Next, use this change in the regression model to obtain the forecasted change for this month:

$$\Delta \ln \text{sales}_t = 0.052 + 0.684(0.0138) = 0.0614$$

Add the forecasted change to last month's log sales to obtain this month's forecasted log sales:

$$\ln \text{sales}_t = 0.0614 + 8.7435 = 8.8049$$

Lastly, convert the forecasted log value to a dollar value by taking its antilog:

$$\text{sales}_t = e^{8.8049} = \$6,667$$

For further reference:

Study Session 3, LOS 11.d

SchweserNotes: Book 1 p.193

CFA Program Curriculum: Vol.1 p.415

Question #9 of 60

B) Only Smith is correct.

Explanation

Smith is correct. The first step in testing for an ARCH process is to take the residuals from the original autoregressive model and then square them.

Sims is incorrect. The next step in determining whether an ARCH process exists is to regress the squared residuals from this period against the squared residuals from the previous period as follows:

$$\varepsilon_t^2 = b_0 + b_1 \varepsilon_{t-1}^2$$

If b_1 is statistically different from zero, then we conclude that the regression model contains an ARCH process.

For further reference:

Study Session 3, LOS 11.m

SchweserNotes: Book 1 p.207

CFA Program Curriculum: Vol.1 p.449

Question #10 of 60

A) Neither Lag should be included.

Explanation

Neither the lag two term nor the lag four term should be included. To determine the significance of the autocorrelation of the residuals, we need the standard error, which is calculated as one over the square root of the number of observations. There are 36 quarters of inflation data. One quarter is lost because we have a lag one term, so there are 35 observations in the regression.

$$\frac{1}{\sqrt{35}} = 0.1690.$$

Therefore, the standard error is

The t -statistics are the autocorrelations divided by the standard error which results in:

Lag	Autocorrelation	Standard Error	t -Statistic
1	0.0829	0.1690	0.49
2	0.1293	0.1690	0.76
3	0.0227	0.1690	0.13
4	0.1882	0.1690	1.11

The critical t -value is 2.03 for a two-tail test, so none of the t -statistics indicate that the autocorrelations are significantly different from zero. Therefore, we do not need to include additional lag terms.

For further reference:

Study Session 3, LOS 11.d

SchweserNotes: Book 1 p.193

CFA Program Curriculum: Vol.1 p.415

Question #11 of 60

C) Only Regression 2 is valid.

Explanation

In the first regression, the Federal Funds rate in the United States has a unit root, but the bond yield in the European Union does not. So the former data series is not covariance stationary, but the latter is. In this case, the regression results will not be valid.

In the second regression, both the Federal Funds rate in the United States and the bond yield in Great Britain have a unit root. So both data series are not covariance stationary. However, because they are cointegrated, the regression results will be valid.

To sum up the possibilities you may face on exam day:

- If neither data series has a unit root, the regression results are valid.
- If only one data series has a unit root, the regression results are invalid.
- If both data series have a unit root and they are cointegrated, the regression results are valid.
- If both data series have a unit root and they are not cointegrated, the regression results are not valid.

For further reference:

Study Session 3, LOS 11.k, n

SchweserNotes: Book 1 p.199, 208

CFA Program Curriculum: Vol.1 p.433, 452

Question #12 of 60

C) Engle-Granger.

Explanation

To test whether two variables are cointegrated, we regress one data series on the other and examine the residuals for a unit root using the Dickey-Fuller/Engle-Granger test. If we reject the null hypothesis, the error terms of the two data series are covariance stationary and cointegrated. The regression results will be valid.

For further reference:

Study Session 3, LOS 11.n

SchweserNotes: Book 1 p.208

CFA Program Curriculum: Vol.1 p.452

Question #13 of 60

A) Both are correct.

Explanation

Hoskins's statement is likely to be correct. If the Maldavian government is considering taxing stock market transactions, then this will limit future economic growth. Economic growth is dependent in part on markets, because markets facilitate business transactions between buyers and sellers.

Lanning's statement is also likely to be correct. If the president of Petria nationalizes the oil industry, then private property will be seized and property rights will not have been respected. Without property rights, firms and individuals have little incentive to make investments that could lead to future economic growth.

For further reference:

Study Session 4, LOS 14.a

Question #14 of 60

- C) incorrect, because although labor productivity will increase, the increase will result from a movement along the productivity curve.

Explanation

Hoskins's reasoning is incorrect because although labor productivity will increase, the increase will result from a movement along the productivity curve. An upward shift in the productivity curve requires an advancement in technology.

For further reference:

Study Session 4, LOS 15.d
SchweserNotes: Book 1 p.300
CFA Program Curriculum: Vol.1 p.684

Question #15 of 60

- B) Felicia Felicia

Explanation

Felicia has lower capital to labor ratio and would benefit more from capital deepening. Removal of restrictions on the inflow of capital would lead to more investment and hence capital deepening-again benefiting Felicia more.

For further reference:

Study Session 4, LOS 14.d
SchweserNotes: Book 1 p.279
CFA Program Curriculum: Vol.1 p.613

Question #16 of 60

- C) 2.24%.

Explanation

GDP growth rate = growth rate in TFP + α (long-term growth rate of capital) + $(1 - \alpha)$ (long-term growth rate of labor).

$(1 - \alpha) = 0.52$ and thus $\alpha = 0.48$

$3.9\% = \Delta TFP + (0.48)(1.4) + (0.52)(1.9) \rightarrow \Delta TFP = 2.24\%$

For further reference:

Study Session 4, LOS 14.e
SchweserNotes: Book 1 p.282
CFA Program Curriculum: Vol.1 p.615

Question #17 of 60

- B) settle at subsistence level due to adjustments in the population.

Explanation

Under the classical growth theory, the Tiberian economy will settle at a subsistence level. The high growth in the economy will result in a higher population. The higher population will

eventually result in decreased returns to labor and decreased labor productivity. No permanent increase in labor productivity will result and per capita GDP will settle at a subsistence level.

For further reference:

Study Session 4, LOS 14.i

SchweserNotes: Book 1 p.286

CFA Program Curriculum: Vol.1 p.636

Question #18 of 60

- B) continue to increase because technological advances will be shared by many sectors of the economy.

Explanation

Under the endogenous growth theory, the Tiberian GDP growth rate can continue to increase because technological advances will be shared by many sectors of the economy. Increasing R&D investment, for example, results in benefits not just to the firm making the investment but also to other firms. As these benefits flow to other firms, the economy becomes more productive and the long-term economic growth rate can continue to increase.

For further reference:

Study Session 4, LOS 14.i

SchweserNotes: Book 1 p.286

CFA Program Curriculum: Vol.1 p.636

Question #19 of 60

- C) A build-up of inventory.

Explanation

The balance sheet accrual ratio is the year-over-year increase in net operating assets divided by average net operating assets. An increase in payables (a liability) will tend to decrease (reduce the change in) net operating assets, while an increase in inventory will tend to increase (increase the change in) net operating assets. Cash is not an operating asset and does not affect the ratio.

For further reference:

Study Session 6, LOS 20.e

SchweserNotes: Book 2 p.136

CFA Program Curriculum: Vol.2 p.298

Question #20 of 60

- B) 8.13.

Explanation

The unadjusted interest coverage ratio is calculated as follows:

$$\text{interest coverage} = \frac{\text{EBIT}}{\text{interest expense}} = \frac{10,876.00}{693.00} = 15.69$$

To adjust the interest coverage ratio for the operating lease, we need to take EBIT and add back the lease/rental expense (the lease payment amount) and subtract an estimate of depreciation for the machinery. Then, we need to add the appropriate interest expense for the operating lease to the overall interest expense.

To compute the interest expense and depreciation for the operating lease, we must first calculate the present value of the operating lease as follows:

$$\text{PMT} = 2,000$$

$$\text{I/Y} = 9$$

$$\text{N} = 5$$

$$\text{FV} = 0$$

$$\text{CPT} \rightarrow \text{PV} = 7,779.30$$

Depreciation and interest expense are then calculated as:

$$\text{depreciation} = \frac{7,779.30}{5} = 1,555.86$$

$$\text{interest expense} = 7,779.30 \times 0.09 = 700.14$$

The adjusted interest coverage ratio is:

$$\text{interest coverage}_{(\text{adjusted})} = \frac{\text{EBIT} + \text{operating lease rent expense} - \text{depreciation}}{\text{interest expense} + \text{interest expense}}$$

$$\text{interest coverage}_{(\text{adjusted})} = \frac{10,876.00 + 2,000.00 - 1,555.86}{693.00 + 700.14} = 8.13$$

For further reference:

Study Session 6, LOS 20.c

SchweserNotes: Book 2 p.142

CFA Program Curriculum: Vol.2 p.289

Question #21 of 60

C) an increase in financial leverage ratios and a decrease in the interest coverage ratio.

Explanation

The elimination of the securitization of receivables as an off-balance-sheet item would result in Konker having to report the transaction as securitized borrowing, replacing the receivables on the balance sheet, and reporting a liability equal to the proceeds of the securitization transaction. The impact on Konker's balance sheet would be an increase in assets, and an increase in liabilities. The change in equity from reporting the transaction in this way is likely to be small. Financial leverage would increase, and the consequent increase in interest expense from the liability would decrease the interest coverage ratio.

For further reference:

Study Session 5, LOS 16.c

SchweserNotes: Book 2 p.24

CFA Program Curriculum: Vol.2 p.35

Study Session 6, LOS 20.d

SchweserNotes: Book 2 p.143

CFA Program Curriculum: Vol.2 p.302

Question #22 of 60

B) an increase in the asset turnover ratio.

Explanation

Removing the effects of the income reported under the equity method involves removing the income and the equity asset reported on the balance sheet. The decrease in total assets will increase the asset turnover ratio. The tax burden term is net income divided by earnings before tax so that the decrease in net income from removing the equity income will decrease the term (an apparently greater reduction in ROE due to taxes). Neither interest expense nor operating earnings (EBIT) are affected by the appropriate adjustments, so the interest coverage ratio is unaffected.

For further reference:

Study Session 6, LOS 20.b

SchweserNotes: Book 2 p.127

CFA Program Curriculum: Vol.2 p.281

Question #23 of 60

A) Konker is growing the Industrial division over time.

Explanation

The fact that Konker is growing the Industrial division most rapidly (highest capex percent to asset percent ratio) is a likely cause for concern and further investigation, since this division has the lowest operating return on assets. The decrease in the operating ROA for the Capital division is not particularly troublesome as it mirrors the pattern for the other divisions and likely just reflects year-to-year variation in profitability. The fact that the percent of capex for the Defense division is less than its percent of total assets is not a primary cause for concern since that division has a lower operating ROA, and growth in capital assets likely follows contract awards in the defense industry, rather than drives business. Also, the apparent overinvestment in the Industrial division will decrease the capex percent for other divisions, other things equal.

For further reference:

Study Session 6, LOS 20.b

SchweserNotes: Book 2 p.127

CFA Program Curriculum: Vol.2 p.281

Question #24 of 60

A) The volatile accruals ratios are indicators that Konker may be manipulating earnings.

Explanation

Volatile accruals ratios are an indicator that a firm may be manipulating earnings. Additionally, increasing accruals ratios may be a sign that a firm may be manipulating earnings. Lower accrual ratios represent higher earnings quality.

For further reference:

Study Session 6, LOS 20.b

SchweserNotes: Book 2 p.127

CFA Program Curriculum: Vol.2 p.281

Question #25 of 60

B) balance sheet assets and liabilities of the purchased firm would have been reported at fair value.

Explanation

The assets and liabilities of the purchased firm are included on the balance sheet of the acquiring firm under either method. Under the pooling method, there is no adjustment of balance sheet asset and liability values to their fair values. Under the acquisition method, assets and liabilities

acquired are reported at fair value at the time of the purchase. There is no goodwill reported under the pooling method; the purchase price is not reflected on the balance sheet of the acquiring firm.

For Further Reference:

Study Session 5, LOS 16.a

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #26 of 60

C) net income would not have been affected.

Explanation

Under the acquisition method, the investee firm's revenue and expenses would be reported on Fisher's income statement, increasing both expenses and revenues. Under the equity method, Fisher's revenue and expenses are reported without adjustment, and the proportion of income from the purchased firm is reported separately, so that net income is the same under either method.

For Further Reference:

Study Session 5, LOS 16.a

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #27 of 60

C) must be reviewed for impairment at least annually with different tests for impairment under IFRS and U.S. GAAP. The losses on impairment cannot be reversed under either U.S. GAAP or under IFRS.

Explanation

Goodwill is not amortized under IFRS or U.S. GAAP. The test for impairment is different under IFRS than under U.S. GAAP. Impairment losses cannot be reversed under U.S. GAAP nor under IFRS.

For Further Reference:

Study Session 5, LOS 16.b

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #28 of 60

C) report more or less goodwill depending on the accounting method they choose.

Explanation

All business combinations (e.g., merger, purchase, or consolidation) are reported under the acquisition method. Identifiable assets and liabilities must be reported at fair value at the time of the acquisition. Under IFRS, Fisher has the option of calculating the goodwill for the acquisition under either the full goodwill or partial goodwill methods. Goodwill is less under the partial goodwill method.

For Further Reference:

Study Session 5, LOS 16.b

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #29 of 60

C) Return on equity is lower and debt-to-total capital is not affected.

Explanation

U.S. GAAP requires that unrealized gains and losses on available-for-sale securities be reported in comprehensive income as part of shareholders' equity. The appropriate adjustment to Fisher's statements is to decrease net income by the amount of the gain. Lower net income will result in lower ROA and ROE (lower numerators). Lower net income results in lower retained earnings. However, the gain increases other comprehensive income; thus, total equity does not change. In summary, assets, liabilities and total equity are not affected by the adjustment; thus, asset turnover, debt-to-equity and debt-to-total capital are not impacted.

For Further Reference:

Study Session 5, LOS 16.a,b

SchweserNotes: Book 2 p.1

CFA Program Curriculum: Vol.2 p.10

Question #30 of 60

C) Decrease Decrease

Explanation

The acquisition method results in higher assets and higher sales, but the same net income. Therefore, both ROA (net income divided by assets) and net profit margin (net income divided by sales) will decrease.

For Further Reference:

Study Session 5, LOS 16.c

SchweserNotes: Book 2 p.24

CFA Program Curriculum: Vol.2 p.35

Question #31 of 60

A) Gain on the balance sheet.

Explanation

Exposure under the current rate method is equity. Beginning equity is positive (R4,000) and the change in equity during the year is positive (R6,000 - R4,000 = R2,000). Because the Rho appreciated during the year, the current rate method will report a translation gain for 2008. Under the current rate method, gains and losses are reported as part of the cumulative translation adjustment in the equity section of the balance sheet.

For Further Reference:

Study Session 5, LOS 18.e, f

SchweserNotes: Book 2 p.69, 77

CFA Program Curriculum: Vol.2 p.143, 153

Question #32 of 60

B) Loss on the income statement.

Explanation

- **References**

Exposure under the temporal method is cash and accounts receivable minus current liabilities and long-term debt. Beginning exposure is negative ($R5,000 - R11,000 = -R6,000$) and the change in exposure is also negative [$-R6,300 - (-R6,000) = -R300$]. Because the Rho appreciated during the year, the temporal method will report a translation loss for 2008. Gains and losses are reported on the income statement under the temporal method.

For Further Reference:

Study Session 5, LOS 18.e, f

SchweserNotes: Book 2 p.69, 77

CFA Program Curriculum: Vol.2 p.143, 153

Question #33 of 60

B) Larger on Rho statements.

Explanation

If the Rho is appreciating, mixed ratios, like return on assets and total asset turnover (using end-of-period balance sheet figures), calculated from the local currency statements, will be larger than the same ratios calculated from the reporting currency statements that were translated using the current rate method. For example, under the current rate method, net income will be translated at the lower average rate (\$0.42) and assets will be translated at the higher ending rate (\$0.45). Therefore the original return on assets (net income divided by total assets) from the Rho statements will be higher than the ratio after it is translated into the reporting currency.

For Further Reference:

Study Session 5, LOS 18.e, f

SchweserNotes: Book 2 p.69, 77

CFA Program Curriculum: Vol.2 p.143, 153

Question #34 of 60

B) Lower under the current rate method.

Explanation

With the Rho appreciating, fixed asset turnover will be lower under the current rate method.

For Further Reference:

Study Session 5, LOS 18.e, f

SchweserNotes: Book 2 p.69, 77

CFA Program Curriculum: Vol.2 p.143, 153

Question #35 of 60

C) Use the current rate for translation with any gains or losses reflected in the income statement.

Explanation

This is an example of transaction exposure for Wayward. The translation of Wayward's Del-denominated receivables to Rho would occur at the current exchange rate (i.e., the exchange rate at balance sheet date) and any gains or losses would be reflected in the income statement.

For Further Reference:

Study Session 5, LOS 18.b

SchweserNotes: Book 2 p.62

CFA Program Curriculum: Vol.2 p.118

Question #36 of 60

A) Neither the quick ratio nor the interest coverage ratio will change.

Explanation

The quick ratio (cash and receivables divided by current liabilities) is a pure balance sheet ratio, which means both numerator and denominator will be translated at the current exchange rate and the ratio will be the same before and after translation. The result is the same for the interest coverage ratio (EBIT divided by interest expense) because it is a pure income statement ratio; both the numerator and denominator will be translated at the average rate over the reporting period and the ratio will be the same before and after translation.

For Further Reference:

Study Session 5, LOS 18.e, f

SchweserNotes: Book 2 p.69, 77

CFA Program Curriculum: Vol.2 p.143, 153

Question #37 of 60

C) €623 million.

Explanation

Employer contributions	306
Opening Funded Status	810
Closing Funded Status	493
Change in Funded Status	(317)
TPPC = contributions - Δ funded status	\$623

For Further Reference:

Study Session 5, LOS 17.c

SchweserNotes: Book 2, p.41

CFA Program Curriculum: Vol.2 p.78

Question #38 of 60

B) €267 million.

Explanation

Income statement (U.S. GAAP)

Service cost	170
(+) Interest cost	(4.5%) 365
(-) Expected return on assets	(3%) <u>(268)</u>
(=) Periodic pension cost in P&L	267

Since beginning actuarial losses were less than 10% of the greater of beginning PBO or beginning plan assets, there would be no amortization.

For Further Reference:

Study Session 5, LOS 17.c

SchweserNotes: Book 2, p.41

CFA Program Curriculum: Vol.2 p.78

Question #39 of 60

B) 2%.

Explanation

Under IFRS interest income/expense is calculated by applying the discount rate to the opening funded status. Since the plan is overfunded, Clear is reporting net interest income.

Opening funded status:	$8920 - 8110 = 810$
Net interest income:	$810 \times 0.045 = 36.45$
Operating profit as reported:	234
Less net interest income:	(36.45)
Adjusted operating profit:	197.55
Adjusted margin:	$197.55/9777 = 2.02\%$

For Further Reference:

Study Session 5, LOS 17.e

SchweserNotes: Book 2, p.48

CFA Program Curriculum: Vol.2 p.88

Question #40 of 60

B) decreasing it if employer contributions are lower than total periodic pension cost.

Explanation

If the employer contributions are lower than the total periodic pension cost, the company is effectively borrowing from the pension plan. The after-tax difference should be deducted from CFO and added to CFF.

For Further Reference:

Study Session 5, LOS 17.f

SchweserNotes: Book 2, p.50

CFA Program Curriculum: Vol.2 p.97

Question #41 of 60

C) Neither statement is correct.

Explanation

Under IFRS, Remeasurement gains/losses are never amortized into the income statement, they remain in other comprehensive income.

Under U.S. GAAP actuarial gains and losses are amortized using the corridor approach. Amortization removes a gain or loss from OCI and shows it in the income statement. Therefore it has no overall impact on equity.

For Further Reference:

Study Session 5, LOS 17.c

SchweserNotes: Book 2, p.41

CFA Program Curriculum: Vol.2 p.78

Question #42 of 60

C) incorrect as the cost of issuing shares under an employee stock option scheme will not reduce equity.

Explanation

The expense of the employee stock option scheme will be shown as employee compensation expense in the income statement and hence reduce retained earnings. However, there is an offsetting increase in paid-in capital and hence no overall impact on equity.

For Further Reference:

Study Session 5, LOS 17.h

SchweserNotes: Book 2, p.51

CFA Program Curriculum: Vol.2 p.101

Question #43 of 60

C) \$367,400.

Explanation

initial investment outlay

$$\begin{aligned} &= \text{purchase price} + \text{increase in net working capital} \\ &\quad + \text{shipping and installation costs} \\ &= \$700,000 + (\$50,000 - \$20,000) + \$100,000 = \$830,000 \end{aligned}$$

terminal year after-tax non-operating cash flow (TNOCF)

$$\begin{aligned} &= \text{Sal}_T + \text{NWCInv} - T(\text{Sal}_T - B_T) \\ &= 75,000 + 30,000 - 0.4(75,000 - 0) \\ &= 75,000 \end{aligned}$$

after-tax operating cash flow (Year 4)

$$\begin{aligned} &= (S - C)(1 - T) + DT \\ &= (\$750,000 - \$225,000 - \$75,000)(1 - 0.4) + (0.4)(\$56,000) = \$292,400 \end{aligned}$$

The book value at the end of Year 4 is \$0 because total depreciation over the four years was \$800,000.

$$\text{total CF (Year 4)} = \$292,400 + \$75,000 = \$367,400$$

For further reference:

Study Session 7, LOS 21.a

SchweserNotes: Book 2 p.154

CFA Program Curriculum: Vol.3 p.27

Question #44 of 60

C) Both recommendations are incorrect.

Explanation

Both recommendations are incorrect. The \$100,000 is a sunk cost and is thus not a relevant cash flow. Using straight-line depreciation will reduce the present value of the depreciation tax shield and reduce the NPV.

For further reference:

Study Session 7, LOS 21.a

SchweserNotes: Book 2 p.154

CFA Program Curriculum: Vol.3 p.27

Question #45 of 60

B) No, he underestimated the project's NPV by approximately \$7,950.

Explanation

By ignoring the initial \$30,000 cash inflow (recall that you are asked to assume it is an inflow), he has underestimated project NPV by \$30,000. By ignoring the terminal cash outflow of \$30,000,

he has overestimated the project NPV by $\frac{\$30,000}{1.08^4} = \$22,050$.

The net effect is to underestimate NPV by $\$30,000 - \$22,050 = \$7,950$.

For further reference:

Study Session 7, LOS 21.a

SchweserNotes: Book 2 p.154

CFA Program Curriculum: Vol.3 p.27

Question #46 of 60

B) The overall NPV is -\$1 million, and Holbrook is incorrect.

Explanation

The overall NPV of Project 1 = project NPV – option cost + option value

overall NPV = -\$7 million – \$3 million + \$9 million = -\$1 million

Without the option, the NPV of the production facility is negative, and the real option does not add enough value to make the overall project profitable.

Holbrook is incorrect that he needs to wait for more information to make the decision on Project 2. If the NPV of the project without the option is positive, the analyst knows that the project with the option must be even more valuable, and determining a specific value for the option is unnecessary. A real option adds value to a project, even if it is difficult to determine the monetary amount of that value.

For further reference:

Study Session 7, LOS 21.f

SchweserNotes: Book 2 p.171

CFA Program Curriculum: Vol.3 p.52

Question #47 of 60

B) \$48,700.

Explanation

economic income = cash flow – economic depreciation

economic depreciation = beginning market value – ending market value

market value at time t = present value of all remaining cash flows discounted at the WACC

$$\begin{aligned}\text{Year 3 beginning market value} &= \frac{CF_3}{(1 + WACC)^1} + \frac{CF_4}{(1 + WACC)^2} \\ &= \frac{\$318,000}{(1.08)^1} + \frac{\$367,400}{(1.08)^2} = \$294,444 + \$314,986 = \$609,430\end{aligned}$$

$$\text{Year 3 ending market value} = \frac{CF_4}{(1 + WACC)^1} = \frac{\$367,400}{(1.08)^1} = \$340,185$$

Year 3 after-tax operating cash flow (given) = \$318,000

Year 3 economic depreciation = \$609,430 – \$340,185 = \$269,245

Year 3 economic income = \$318,000 – \$269,245 = \$48,755

For Further Reference:

Study Session 7, LOS 21.h

SchweserNotes: Book 2 p.175

CFA Program Curriculum: Vol.3 p.58

Question #48 of 60

C) Both comments are incorrect.

Explanation

Comment 1 is incorrect. Interest should not be included in a project's cash flows when conducting NPV analysis because it is a financing cost that is reflected in the discount rate used to compute NPV.

Comment 2 is incorrect. In theory, when discounted at the WACC, the present value of the economic profits from a project equals the NPV of the project. For a given period, economic profit = NOPAT – \$WACC, where NOPAT is net operating profit after taxes and \$WACC is the dollar cost of the capital used during the period. Economic profit reflects the income earned by all capital providers.

For Further Reference:

Study Session 7, LOS 21.a, i

SchweserNotes: Book 2 p.154, 179

CFA Program Curriculum: Vol.3 p.27, 61

Question #49 of 60

A) Structural models.

Explanation

Structural models require that the company's assets trade in a frictionless arbitrage free market.

For Further Reference:

Study Session 13, LOS 38.f

SchweserNotes: Book 4 p.94

CFA Program Curriculum: Vol.5 p.210

Question #50 of 60

C) For a given state of the economy, whether a company defaults depends only on company-specific considerations.

Explanation

Reduced form models assume that given the macroeconomic state variables, a company's default represents idiosyncratic risk. Structural models assume a constant (non-stochastic) risk-free rate and that the time T value of the assets is characterized by a lognormal distribution.

For Further Reference:

Study Session 13, LOS 38.f

SchweserNotes: Book 4 p.94

CFA Program Curriculum: Vol.5 p.210

Question #51 of 60

B) Point 2 only.

Explanation

Ratings tend to be stable over time, which reduces their correlation to default probabilities; hence, Point 1 is incorrect.

For Further Reference:

Study Session 13, LOS 38.c

SchweserNotes: Book 4 p.90

CFA Program Curriculum: Vol.5 p.192

Question #52 of 60

C) \$23.51.

Explanation

The maximum amount an investor would pay to remove the credit risk is the present value of the expected loss.

For Further Reference:

Study Session 13, LOS 38.d

SchweserNotes: Book 4 p.90

CFA Program Curriculum: Vol.5 p.193

Question #53 of 60

B) risk premium for risk of credit loss exceeds the time value of money discount.

Explanation

The time value of money discount will always reduce the present value of expected loss. Because the present value of expected loss in this case is higher than the expected loss, the risk premium for risk of credit loss must be larger than the time value of money discount.

For Further Reference:

Study Session 13, LOS 38.d

SchweserNotes: Book 4 p.90

CFA Program Curriculum: Vol.5 p.193

Question #54 of 60

B) decrease.

Explanation

Under the option analogy of the structural model, risky debt can be viewed as a portfolio comprising a long position in risk-free debt and a short put option on the company's asset with a strike price equal to the face value of the risky debt. When the asset volatility increases, the value of the put option increases and the value of the portfolio with short exposure to the put option will decrease. Hence the computed value of risky debt will be lower.

For Further Reference:

Study Session 13, LOS 38.d

SchweserNotes: Book 4 p.90

CFA Program Curriculum: Vol.5 p.193

Question #55 of 60**C)** \$44.0 million.**Explanation**

Using direct capitalization:

Cap rate data:

<i>Office Building</i>	<i>Craig Court</i>	<i>Kenton Place</i>	<i>Hester Oasis</i>
Cap rate	\$2.56 / \$32.0 = 8.0%	\$1.80 / \$24.0 = 7.5%	\$3.15 / \$45.0 = 7.0%

The average cap rate for the three apartment buildings is 7.5%. The estimated value of Parkway Terrance is calculated as the NOI of \$3,300,000 divided by the cap rate of 7.5%, or \$44.0 million.

For further reference:

Study Session 15, LOS 43.g

SchweserNotes: Book 5 p.9

CFA Program Curriculum: Vol.6 p.29

Question #56 of 60**B)** \$42.2 million.**Explanation**

Using the sales comparison approach:

<i>Variable</i>	<i>Craig Court</i>	<i>Kenton Place</i>	<i>Hester Oasis</i>
Sale price	\$32,000,000	\$24,000,000	\$45,000,000
Size	200,000	150,000	300,000
Sale price per sq ft	\$160.00	\$160.00	\$150.00
Age adjustment	-4.5%	0.0%	+4.5%
Condition adjustment	+7.5%	0.0%	0.0%
Location adjustment	0.0%	+7.5%	+7.5%
Date of sale adjustment	+4.5%	+2.5%	+8.0%
Total adjustments	+7.5%	+10.0%	+20.0%
Adjusted sales price psf	$\$160 \times (1 + 0.075)$ = \$172.00	$\$160 \times (1 + 0.100)$ = \$176.00	$\$150 \times (1 + 0.200)$ = \$180.00

Average sales price per square foot is \$176.00. The sales comparison method estimates the value of the property at 240,000 square feet \times \$176.00 = \$42.2 million.

For further reference:

Study Session 15, LOS 43.i

SchweserNotes: Book 5 p.18

CFA Program Curriculum: Vol.6 p.46

Question #57 of 60**A)** not worth pursuing because the equity dividend rate is below the minimum required.**Explanation**

	<i>Parkway Terrace</i>	<i>Standards</i>
NOI	\$3,300,000	
Equity ¹	\$10,000,000	
Annual Debt Service	$\$166,750 \times 12 = \$2,001,000$	
Equity Dividend Rate	$= (\$3,300,000 - \$2,001,000) / \$10,000,000 = 13.0\%$	13.0% is less than 25.0%
DSCR	$\$3,300,000 / \$2,001,000 = 1.65X$	1.65X exceeds 1.50X
Cash flows (PMT)	$\$3,300,000 - \$2,001,000 = \$1,299,000$	
Equity (PV)	\$10,000,000	
Sales Price - Outstanding Loan in 10 Years (FV)	$\$60,000,000 - \$21,797,543 = \$38,202,457$	
Sales Date (N)	10	
Levered IRR ²	22.6%	22.6% exceeds 20.0%

1. LTV = 75% (given), Equity = 25% of 40 million.

2. Levered IRR calculation: N = 10; PV = -10,000,000; PMT = 1,299,000; FV = 38,202,457; CPT → I/Y = 22.56%

For further reference:

Study Session 15, LOS 43.m

SchweserNotes: Book 5 p.24

CFA Program Curriculum: Vol.6 p.62

Question #58 of 60**B)** \$41.0 million.**Explanation**

Value of land (given)		\$12,500,000
Replacement cost, including constructor's profit		
Building costs (psf)	\$175	
Total area	240,000	\$42,000,000
Developer's profit	<u>\$15</u>	<u>\$3,600,000</u>

		\$45,600,000	
Reduction for curable deterioration		<u>-\$5,000,000</u>	
		\$40,600,000	
Reduction for incurable deterioration			
Total economic life	50		
Remaining economic life	40		
Effective age	10		
Ratio of effective to total	20.0%		
Reduction for incurable deterioration		<u>-\$8,120,000</u>	
		\$32,480,000	
Reduction for total obsolescence		<u>-\$4,000,000</u>	
Total building value			\$28,480,000
Total Cost Estimate			\$40,980,000

For further reference:

Study Session 15, LOS 43.i

SchweserNotes: Book 5 p.18

CFA Program Curriculum: Vol.6 p.46

Question #59 of 60

A) Chun Park's.

Explanation

The economic outlook on home prices and population trends indicate favorable conditions going forward. Shorter leases would allow rents to be adjusted upwards as demand for rentals increase, so Lundy's comment is correct. For a buyer of real estate, low interest rates along with a high loan-to-value (LTV) will maximize the potential for high levered returns. Tenants will benefit from longer leases in a high demand environment; this would not benefit the investors so Park's comment is incorrect.

For further reference:

Study Session 15, LOS 43.c, d

SchweserNotes: Book 5 p.4, 6

CFA Program Curriculum: Vol.6 p.13, 19

Question #60 of 60

C) Use more-recent appraisals.

Explanation

Appraisal lag tends to smooth the reported returns of real estate indices, resulting in an artificially low correlation with other asset classes. Appraisal lag can be mitigated by unsmoothing the index or by using a transaction-based index. Using more-recent appraisals still relies on appraisal-based data.

For further reference:

Study Session 15, LOS 43.k

SchweserNotes: Book 5 p.23

CFA Program Curriculum: Vol.6 p.57